United Kingdom: Staff Concluding Statement of the 2018 Article IV Mission

September 17, 2018

Outlook and Risks

Despite strong policy frameworks and implementation, growth has moderated since the European Union referendum in June 2016. Uncertainty over the terms of the EU withdrawal has weighed on private sector activity. Above-target inflation following the sharp post-referendum sterling depreciation has slowed real income and consumption growth. Business investment has been lower than would be expected in the context of robust global growth and favorable financing conditions. The softening of domestic demand was partially offset by a higher contribution from net exports, supported by weaker sterling and strong external demand. Overall, growth fell to about 1¾ percent in 2016-17, moving the United Kingdom from the top to near the bottom of the G7 growth tables. The employment rate, however, continues to reach record highs.

The UK is set to exit the EU in March 2019 and aims to reach a broad agreement with the EU on their future relations by the end of 2018. Our projections assume timely agreement on a broad trade pact covering goods and some services, and a relatively smooth Brexit process thereafter. Growth is expected to remain moderate in the near term under this baseline, averaging about 1½ percent this year and next. With the economy operating at very low unemployment and household saving already at a very low rate, consumption growth will be broadly in line with subdued real income growth. Investment is also likely to remain constrained as long as Brexit uncertainty weighs on firms. A more disruptive departure from the EU could lead to a significantly worse outcome, especially if it were to occur without an implementation period. By contrast, an agreement featuring fewer impediments to trade than currently expected could buoy business and consumer confidence, leading to faster growth.

Brexit negotiations have yielded agreement in principle on a 21-month implementation period. If ratified, this would allow important additional time to prepare for the new relationship between the UK and EU. However, fundamental questions—such as the future economic relationship between the two and the closely-related question of the status of the land border with Ireland—remain unanswered. Resolving these issues is critical to avoid a “no deal” Brexit on WTO terms that would entail substantial costs for the UK economy—and to a lesser extent the EU economies—particularly if it were to occur in a disorderly fashion. While all likely Brexit outcomes will entail costs for the UK economy by departing from the frictionless single market that now prevails, an agreement that minimizes the introduction of new tariff and nontariff barriers would best protect growth and incomes in the UK and EU. Over time, new trade agreements with countries outside the EU could eventually pare some of these losses for the UK. However, such agreements are unlikely to bring sufficient benefits to offset the costs imposed by leaving the EU.

The UK government has taken a number of steps to prepare for the administrative and legislative changes that Brexit will require. The government has committed to act in several areas to provide continuity at the moment of departure from the EU. Parliament is in the process of transposing into UK law the legislative framework currently encompassed in EU laws, and the government has guaranteed EU program funding committed to projects in the UK before the end of 2020 and is working to ensure that the UK maintains access to critical items like medicines. A budgetary allocation of £3 billion has been established to help fund the costs of Brexit preparation, and thousands of civil servants have been hired to help shoulder the workload. Brexit preparations are a shared responsibility of the public and private sectors. The government has begun publishing technical notices setting out information to allow private stakeholders to understand what they would need to do in a "no deal" scenario, so they can make informed plans and preparations.

Nevertheless, the range of remaining issues to prepare for Brexit is daunting, underscoring the importance of securing an implementation period. The UK will have to bolster human, physical, and IT resources in customs and other services, and establish domestic agencies to replace EU ones. In addition, the government will need to renegotiate the hundreds of bilateral and multilateral international agreements to which it is now party via its EU membership. Many of the required tasks cannot be initiated until there is greater clarity on the future trade relationship with the EU or even until Brexit occurs. The massive scope of work that remains and the limited time before the UK exits the EU would likely leave preparations incomplete on departure day despite even the most determined efforts. This risks serious disruptions without an implementation period in place. Coordination and cooperation between the EU and UK on priority issues, such as ensuring air traffic continues to flow, would be to the benefit of both parties. Joint technical discussions between UK and EU experts could facilitate this process.

Beyond Brexit, the UK faces a range of other economic challenges. These include persistently lackluster productivity growth, large public debt, and the wide current account deficit. The UK's sound macroeconomic framework, regulatory environment, and deep capital and flexible labor markets will be advantages in implementing reforms to address them.

Monetary and Fiscal Policies

After a cumulative 50 basis point increase in Bank Rate over the last 12 months, further withdrawal of monetary stimulus should await clear confirmation of a durable rise in domestic cost pressures. The inflationary impact of the post-referendum depreciation of sterling should continue to fade. At the same time, domestic inflation is likely to firm as the tight labor market pushes real wage growth above productivity growth. If excess demand pressures persist after domestic inflation has approached a level consistent with the 2-percent target, further gradual tightening of monetary policy would be warranted. However, policymakers should respond flexibly to data developments in an environment of greater-than-usual uncertainty. If negative surprises depress domestic demand, accommodative conditions should be maintained for longer. The scaling down of the Bank of England's balance sheet should await the return of Bank Rate to a level from which it could be cut materially in the event of a demand slowdown, consistent with the Monetary Policy Committee's current plans. Transparent and timely communication to guide market expectations continues to be essential.

Steady fiscal consolidation remains critical to comply with the government's fiscal framework and to put debt firmly on a downward path. Fiscal consolidation over the last decade has substantially reduced deficits, but public debt remains relatively high from a cross-country perspective. Bringing the debt ratio down is important to create buffers that will allow the public finances to weather future shocks, as noted in the authorities' welcome report on *Managing Fiscal Risks*. Accordingly, the recently-announced increase in public health spending should be financed from new revenue sources and/or offsetting spending cuts elsewhere in the budget. In the absence of offsetting measures, the margin against the cyclically adjusted deficit ceiling of 2 percent in 2020/21 would be significantly reduced, and the debt ratio would not decline in the medium term.

Brexit-related effects could exacerbate existing fiscal challenges. Each 1 percentage point decline of GDP leads to about a 0.4 percentage point increase in the budget deficit. Most analysts project output costs relative to a no Brexit scenario to be well above this. If Brexit disproportionately affects relatively tax-rich sectors like finance, the revenue impact could be even larger. Reduced migration will also have a negative budgetary impact, as EU migrants tend to be both younger and better skilled than average, making them net contributors to the fiscal accounts. These factors exceed any savings from lower net EU contributions and will come on top of longer-term budget pressures that pre-date Brexit.

As in many advanced economies, population aging is likely to put considerable pressure on the budget over the longer term. The Office for Budget Responsibility estimates that public spending on health care and pension benefits will increase by a cumulative four percentage points of GDP between 2023 and 2043. Opportunities for further efficiency gains in the NHS should be explored, and the elimination of the "triple lock" could lead to important savings over time on pensions. While the government should continue to seek the best value for money in public spending, after several years of primarily expenditure-based consolidation identifying further efficiency gains could become difficult. Absent a fundamental rethinking of the size and role of the public sector, revenue measures will therefore need to occupy a more prominent place in deficit reduction efforts going forward.

More broadly, tax reforms can reduce economic distortions and increase fiscal space. Scaling back preferential VAT rates would increase tax neutrality. Better aligning the tax treatment of employees and the self-employed would improve fairness and bring the tax system in line with evolving employment practices. Financial stability could be enhanced by reducing the tax code's bias toward debt, for example by adopting a tax allowance for corporate equity. Rebalancing property taxation away from transactions and toward values would boost labor force mobility and encourage more efficient use of the housing stock.

Contingency Planning

Under a disorderly Brexit scenario, policies should seek to safeguard macroeconomic and financial stability. In the event of sharp declines in sterling and other asset prices, the Bank of England would need to ensure that the financial system has adequate liquidity. The implications of Brexit for monetary and fiscal policy are uncertain: the response will depend on the relative shifts of supply and demand, as well as the extent of sterling depreciation. The fiscal framework provides flexibility to support the economy, for example through bringing forward infrastructure spending. However, the space to respond could narrow if the shock were to significantly raise interest rates on public debt. Any easing of fiscal policy should therefore be temporary and embedded in a credible medium-term fiscal consolidation plan. A permanent shock to output would require an eventual adjustment of revenues or spending.

Financial Sector Policies

Bank balance sheets have continued to improve. Capital, leverage, and liquidity positions are strong. The countercyclical capital buffer requirement will increase to 1 percent in November, reflecting the Financial Policy Committee's view that apart from Brexit-related risks the financial sector is operating in a standard risk environment. The Bank of England's 2017 stress tests indicate that the major UK banks are all sufficiently well-capitalized to withstand simultaneous UK and global recessions, large falls in asset prices, and stressed misconduct costs. Banks subject to the ringfencing requirements are on track to meet the January 2019 deadline. With the recent adoption of the MiFID II framework, investor protection has been strengthened and transparency increased.

Without continued supervisory vigilance, relatively easy financing conditions could lead to increasing prudential risk. Household and corporate leverage have started to edge up, although they remain below pre-crisis levels. Total lending is growing broadly in line with GDP. However, consumer credit—the quality of which is more sensitive to income and interest rate shocks—continues to rise much faster than income, despite recent tightening of underwriting standards.

Further policy action may be needed if high rates of growth persist, including additional increases in bank-specific capital buffers and steps to enhance the oversight of nonbank financial institutions. Other areas of potential vulnerability include the valuation of commercial real estate and to some extent housing. CRE prices remain high and have continued to rise after a short-lived dip following the EU referendum. The ratio of new mortgage loans at relatively high loan-to-income ratios has increased somewhat in the last two years, although the share of highly indebted households remains low. Supported by strong risk appetite in global markets, market-based corporate borrowing has expanded rapidly, with significant foreign investment in CRE and leveraged loans. The authorities' effort to collect information on leverage outside the banking system and assess potential vulnerabilities is welcome. More broadly, the commitment of the FPC and Prudential Regulation Authority to continue to implement robust prudential standards that would maintain a level of financial sector resilience post-Brexit that is at least as great as that currently planned is commendable.

The UK's current account deficit has narrowed, but it remains large in absolute terms and financing trends are a potential concern. Higher returns on UK-owned assets held abroad and higher revenues from net trade led to a narrowing of the current account deficit to 3.9 percent of GDP last year. This is a significant improvement over the deficits of around 5 percent of GDP that prevailed in recent years. However, the share of external financing that is short-term and therefore subject to financing risks—such as wholesale deposits in banks—has risen. Associated stability risks are limited by the strong capital and liquidity positions of UK banks, as well as the high credibility of the fiscal and monetary policy frameworks. Nevertheless, this trend should be monitored carefully, especially in an environment where rising US interest rates and concerns about the UK's long-term growth potential may affect refinancing prospects. Continued fiscal consolidation should help further reduce the current account deficit over time.

The UK has taken a proactive approach to supporting the Brexit preparations of regulated financial institutions and mitigating financial stability risks. Potential risks include disruptions to the provision of financial services, shifts in asset prices and liquidity conditions, and a deterioration of balance sheets from macroeconomic shocks. The Bank of England has stated that its 2017 annual cyclical stress test suggests the major UK banks are sufficiently well-capitalized to withstand a range of macroeconomic risks that could be associated with Brexit. The UK government is focused on identifying and mitigating potential stability risks that could arise during the Brexit transition. For example, legislation is being prepared to create temporary permissions and recognition regimes to allow EEA financial services firms, funds, and central counterparties to continue their activities in the UK for a time-limited period after the UK has left the EU, providing a backstop in case a Brexit agreement is not ratified.

Regulatory and supervisory cooperation between UK and EU authorities will be crucial to maintaining the integrity of cross-border financial transactions. A technical working group, chaired by the heads of the Bank of England and the European Central Bank, has been established to discuss Brexit-related risk management. As suggested in the recent Euro Area FSAP, the EU and UK authorities should work together to ensure legal continuity in insurance and derivative contracts and proper data sharing to avoid cliff-edge effects, which could potentially be highly disruptive.

Structural Policies

Over the long run, UK living standards will predominantly depend on productivity growth. Productivity levels and growth in the UK lag those in peer economies, meaning that output growth has depended largely on increases in employment. The scope for substantial future employment gains is limited, as the unemployment rate is around historic lows and the rate of net immigration of workers from the EU is already falling. Therefore, economic performance will increasingly depend on the ability of firms to raise output per worker. Here, too, the implications of Brexit are largely negative: reduced migration will result in less efficient matching of jobs and workers, while a more closed UK economy will be less competitive and a less attractive environment for foreign direct investment.

Further sustained policy efforts are needed to support productivity and help reduce income inequality and regional disparities. Inequality has declined since the crisis, but remains high compared to other advanced economies, and intergenerational income mobility is low. At the regional level, disparities are large: the UK has some of the most productive regions in any advanced economy, but also some of the least productive. Several initiatives have been announced in recent years to improve infrastructure and human capital. The introduction of T-level qualifications and the apprenticeship levy aim to raise job-specific skills and to promote higher level technical skills and reduce regional disparities in skills provision. It will be important to monitor and evaluate the effectiveness of these programs once they have been in place for some time. A £31 billion National Productivity Investment Fund has been created, which targets investments in transport, housing, digital, and research and development. Infrastructure investment is targeted to increase by over 50 percent from 2012/13 to 2020/21, and the fiscal remit for the National Infrastructure Commission aims for sustained public infrastructure investment of 1 to 1.2 percent of GDP over the long-term. An expert review will examine competition challenges in the digital economy and recommend appropriate policy responses by early 2019.

Boosting economic opportunities for women would promote growth and equity. The female participation rate in the UK, at 74 percent, is already relatively high by advanced economy standards. Recent government initiatives have sought to increase it further by improving government support for childcare costs and doubling the free childcare available to 3- and 4-year-olds of eligible working parents. The government has also introduced free childcare for disadvantaged children aged 2. Nevertheless, fully closing the participation rate gap would boost output by around 5 to 6 percent in the long run. Policies to facilitate job sharing and compressed work schedules could be helpful in this regard. Efforts should also focus on measures to close the gender pay gap (which stands at 10 percent on average for full-time employees) and to increase representation of women in senior positions and in corporate boards, where they remain relatively few in number. Recently-enacted legislation requiring larger firms to make public data on gender pay gaps has helped focus attention on pay disparities.

Brexit will lead to important shifts in the structure of the UK economy and policies could play a role in facilitating the transition. Changes in the trade and migration regimes are likely to vary in effect across industries and regions. Government policies could help smooth the flow of workers both geographically and across economic sectors. In particular, the increased use of active labor market policies, including support for re-training such as the National Retraining Scheme, policies that promote entrepreneurship, higher investment in research and development, and reforms to promote housing supply and mobility could facilitate the transition and reduce the associated costs. Policies should seek to support workers and not particular jobs or sectors.

Corporate transparency has further strengthened. Measures to verify beneficial ownership information of UK companies in the People with Significant Control register continue to be developed and implemented. Financial institutions should be required to report discrepancies in the PSC register. The proposal for a register for foreign owners of UK real estate is also welcome and should include verification measures. The new Office for Professional Body Anti-Money Laundering Supervision is expected to improve consistency of professional body AML supervision in the accountancy and legal sectors, especially firms that provide trust and company services. Continued exchange of ownership information on companies and trusts among the UK authorities, Crown Dependencies, and British Overseas Territories is important.